

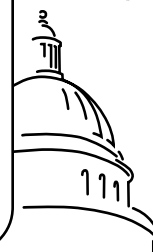
Achieving Energy Independence

In 1996, California deregulated the State's electricity markets. Through a variety of factors, including a lack of investment in new generation capacity and the failure of federal regulators to police the market, the electricity market broke down, leading to a dramatic run up in spot market prices in late 2000 and 2001. The failure of the market required the State to intervene to keep electricity flowing to California's citizens and businesses and led one of the State's investor-owned utilities to file for bankruptcy and another to the brink of insolvency.

The Administration acted quickly to secure a reliable supply of power through conservation, generation capacity, and pressure on the Federal Energy Regulatory Commission (FERC) to implement price caps.

- ❖ California had not built a major power plant in the State in the 13 years prior to this Administration. The Administration took action to change this situation by encouraging investment in power plants and expediting the process of authorizing power plant sites. Consequently, during the past year of this Administration, more than 18 new power plants totaling 3,961 megawatts (mW) have come on line. An additional 280 mW of peaker facilities have also become available as a result of Administration efforts.
- ❖ California also has embarked on the most massive conservation effort ever undertaken by providing \$770.8 million for conservation programs that resulted in reducing peak demand by 3,106 mW in the summer of 2001. These programs include: (1) improved building and appliance energy efficiency standards, (2) loans, grants, and technical assistance to schools, colleges, local governments, and the private sector for the installation of more efficient lighting, insulation, and machinery, and (3) rebates to energy customers for the installation of energy efficient appliances.
- ❖ The Administration has further committed to increasing California's total renewable energy production from today's 12 percent to 17 percent by 2006. The Administration ensured this when it extended the Public Interest Energy Research Program (PIER) and Renewable Energy Program through 2012. Combined, these programs commit \$197.5 million annually to the development of clean, efficient, and more affordable energy sources.
- ❖ The Administration's "20/20" Program committed \$279 million in incentives to energy customers to reduce their energy consumption. As a result of this and other Administration conservation programs, peak demand was reduced by a staggering 14 percent, 11 percent, and 9 percent in June, July, and August 2001, respectively.

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- ❖ The Administration provided the leadership to bring pressure on FERC to do its job and rein in an out-of-control energy market. Ultimately, FERC ordered price caps and required generators to make their power available to California. The FERC orders have brought at least temporary stability to the market place. However, these FERC orders would not have happened had it not been for the Administration's tireless efforts to document the dysfunctional workings and excesses of the energy market, and to investigate the true reasons for the power plant shut downs that constrained energy supplies and helped drive up costs.

Having stabilized the market, the Administration is working, through conservation and the creation of new generation capacity, to ensure that electricity will continue to flow to citizens and businesses at reasonable rates. Efforts continue to finance the State Department of Water Resources' (DWR) energy purchases so that the General Fund can be repaid for the funds advanced. Efforts to renegotiate long-term power contracts are underway so as to garner greater value for the ratepayers from these agreements.

Assuming that California is able to assure a reliable supply of electricity in the short term through conservation and additional generation capacity, significant issues remain:

- ❖ Who will be responsible for purchasing the "net short" energy after December 31, 2002, when DWR's existing authority expires?
- ❖ Has the market been restructured appropriately to ensure that sufficient generation capacity will be forthcoming to assure California's energy independence?
- ❖ How can the State ensure that the outstanding conservation efforts of California citizens and businesses continue in 2002 and future years?

The Administration proposes to work collaboratively with the Legislature to address these issues. Specifically, the Administration proposes to work with the legislative leadership to address these issues and ensure California's energy independence.

Purchasing the Net Short

In January 2001, pursuant to the Governor's Emergency Proclamation, the DWR began purchasing electricity for the customers of Pacific Gas and Electric Company and Southern California Edison. Generators refused to sell to these utilities because of concerns about their ability to pay for power purchased. In February, DWR began purchasing power (the "net short") for the customers of San Diego Gas and Electric Company.



Pursuant to authorization provided by the Legislature in AB 1X (Chapter 4, First Extraordinary Session, Statutes of 2001), DWR entered into long-term contracts for power. The contracts, along with a number of other factors, have resulted in a significant decline in the price of power in the market.

Under the provisions of AB 1X, DWR is authorized to purchase power only until the end of the 2002 calendar year. However, it is not clear whether the investor-owned utilities (IOUs) on whose behalf DWR has been buying power will be sufficiently credit worthy to take back responsibility for buying power at that point. The Administration believes that DWR should stay in the business of buying power only as long as is absolutely necessary. However, contingencies must be developed to ensure a smooth transition of this responsibility back to the IOUs.

Market Structure

California's energy market remains in a state of transition. The recent bankruptcy filing on the part of Enron, as well as credit rating downgrades for other suppliers, contributes to ongoing instability and uncertainty in the market.

Underlying this instability are fundamental questions concerning the structure of the market itself: Will California's partially deregulated market send the right signals to suppliers and generators to ensure a stable supply? What part can conservation play in meeting the State's power needs? What role should the new Power Authority play in meeting those needs and helping to stabilize the market?

Though the State has succeeded in ensuring a stable supply of power in the short term, the risk is that we have not adequately restructured the market to avoid a repeat of the market dysfunction just experienced. The long lead-times associated with many energy projects demand a combination of planning and market signals that will enable California to avoid the sort of boom and bust cycle that created last year's crisis.

